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Navigating the minefield of the ESA review

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In its review of the European Supervisory Authorities (ESAs), the European Commission is proposing a radical expansion of the competences of the European Securities Markets Authority (ESMA), but without changing the final decision-making structure of the ESAs. Such a change of scale, creating important new powers for ESMA in capital markets' supervisory functions for the EU-27, was not expected by most market participants. With the biggest financial centre soon leaving the EU, the review introduces some provisions on future cooperation with third countries but outside any strategic thinking about the competitiveness and attractiveness of the post-Brexit Capital Markets Union (CMU).

A decade after the start of the financial crisis, the EU supervisory structure is unbalanced between banks and non-banks, between the eurozone and non-eurozone, and between the role of the centre and that of the member states. The supervisory structure for banks is well integrated, but has a strong bias towards central banks and the European Central Bank. The governance structure for the entire financial sector in the ESAs leaves too many powers with the supervisors of member states, in the governing council of the ESAs, as compared with the powers and responsibilities the ESAs have. This is not well suited for the important expansion of ESMA's supervisory powers in the ESA review. Overall, some further rebalancing of the structure is needed to create more of a Single Supervisory Mechanism (SSM) for capital markets, but this does not seem to be on the cards.

The ESAs have so far been mostly *regulatory* bodies, which have mainly assisted the European Commission in rule-making with proposals for implementing standards and guidelines, the member state supervisors in monitoring supervisory convergence, and the markets with Q&As

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on interpretation issues of EU legislation. Only ESMA had supervisory powers for rating agencies and trade repositories, functions that were new at the time. The mood to pass more powers to the EU level has waned in the meantime, apart from the centralisation of banking supervision within the ECB.

The Commission proposes giving ESMA more supervisory powers in five fields. These concern, in order of importance:

1. **Third-country central counterparties** (CCPs) (which was already addressed in the European Markets Infrastructure Regulation 2.0). ESMA will gain far-reaching powers for the authorisation and supervision of 'Tier 2' CCPs, that is, systemically important CCPs of third countries that also clear for EU counterparts. A separate 'executive session' would be set up within ESMA to deal with this.

2. **Administrators of critical benchmarks.** These pertain to benchmarks that underpin reference volumes of at least €500 billion (such as Euribor and Libor). The proposal enables ESMA to authorise the administrators and monitor the equivalence of a third country's supervisory standards. It abolishes the colleges of supervisors that was set up in the 2016 Benchmarks Regulation.

3. Certain **prospectuses for public offerings.** This is probably the element of the proposal that causes the most controversy, as it targets specific segments of offerings, such as bonds, asset-backed securities and special types of companies (for instance, shipping and property companies), which will be uniquely authorised by ESMA for the entire EU.

4. **Data providers** (as further to the Markets in Financial Instruments Directive II). Approved publication arrangements (APAs) and consolidated tape providers should be uniquely authorised by ESMA.

5. EU **venture capital** funds and long-term **investment funds** (ELTIFs). These concern highly specific segments of EU-regulated funds (venture capital and long-term investments) that are very recent and have not yet attracted enough interest.

It is proposed that ESMA receives a larger budget and more staff to cope with the increase in competences. This should in the future be funded by contributions from the EU budget, the supervised entities and the national competent authorities (NCAs). NCAs' contributions should cover for the institutions that the ESAs supervise *indirectly*, which may cause confusion. The proposal also makes a set of changes to the governance of the three ESAs. The Management Board is upgraded to become an executive board, composed of four full-time members, including the chairperson and a vice-chairperson. But the final decision-making remains in the hands of the Supervisory Board, composed of representatives of member state supervisors with qualified majority voting on regulatory issues and with each one voting on supervisory issues, in which the permanent executive members have no vote. Regrettably, the proposal has not explored the possibility of giving permanent executives a vote on supervisory issues within the Supervisory Board. For CCPs, ESMA will need to create an additional structure, called the 'executive session', to work alongside the executive board, although this seems superfluous or too heavy to manage with the extended executive board. Most importantly, it may delay and confuse the decision-making process unnecessarily, above all in times of stress.

The proposal furthermore contains some changes of approach as regards the openness of the single market. Most notable, also in the context of Brexit, is a more stringent scrutiny by the ESAs of the NCAs on the delegation or outsourcing of key functions to third-country entities (Art. 31(a)). Delegation in the asset management sector, namely portfolio/risk management, trading, research, advisory and administration services, is currently rather widespread but some advocate closer control in order to keep the activity within the EU. Before deciding, at least an impact assessment and data collection effort are needed to map the functions and volumes that are delegated to enable a better understanding of the value chain in the EU fund industry. Another proposed change concerns extending the product intervention powers of the Markets in Financial Instruments Regulation (Art. 40) to UCITS and the Alternative Investment Fund Managers Directive (AIFMD), which also includes funds sold by third countries in the EU. This comes on top of the sales restrictions that will already apply for UK-based fund managers after Brexit, when funds will become non-EU alternative investment funds following the AIFMD.[1]

The proposal faces a bumpy decision-making process. Some countries, industry associations and firms have already taken a very strong stance against certain aspects of the proposal. Overall, questions can be raised about the rationale of the sudden expansion of ESMA's powers in some of the fields mentioned, or why this was not done earlier, for example for benchmarks, prospectuses or data providers, as it all concerns changes to very recent pieces of legislation. In another example, the market segments where ESMA will have unique authorisation powers for public offerings are not directly those where significant market integration justifies it. Why not prioritising single pan-European IPOs for European blue chip companies? The corollary of simultaneously changing elements of the governance of the ESAs and expanding the powers of ESMA is that it has created a dangerous recipe for horse-trading and power plays between different member states and interest groups, the outcome of which is difficult to predict at this stage. In addition, it does not really correct the imbalances in the EU's supervisory structure.

Some further observations can be made regarding the review:

1) The ESA review can no longer be carried out for the three authorities at the same time. Since their establishment in 2010, the ESAs have started to take on different lives. The role of the European Banking Authority (EBA) was changed by the creation of the SSM, and it has mainly become a standard-setting agency for the EU-28. With the CMU and Brexit, the responsibilities of ESMA have further grown, apart from the specific supervisory tasks it already had. For the European Insurance and Occupational Pensions Authority, the tasks may grow from the mostly regulatory ones of today as a result of the pan-European pension product proposal, although this may still take some time. These differences between the

[1] See https://ec.europa.eu/info/sites/info/files/180208-notice-withdrawal-uk-asset-management_en.pdf.

responsibilities of the three bodies can also be observed from their differences in budget and employees.[2]

2) Related to the above is the structure for accountability. A standard-setting authority has a different accountability structure than an entity that is becoming a full-fledged supervisory body. In the case of ESMA, the ESA's traditional accountability structure may no longer be up to its task. A more regular formal appearance before the European Parliament should be considered, as is the case with the SSM.

3) Furthermore, also the governance and appointment procedures for the chairperson and the executive board of the ESAs should be addressed. A merely standard-setting agency for the European Commission requires different processes and administrative grades than if it becomes a more independent supervisory agency, as is the case for ESMA. The executive chair of ESMA will become a powerful person, having supervisory competence over an important group of capital market actors and products. A more forward-looking selection process should be contemplated to select these top officials, who will be representing the EU in the global financial markets community.

4) The overlaps or division of labour between the EBA and the SSM should have been addressed. With the UK leaving the EU, and the SSM getting to cruise speed, it can be expected that more countries will join the SSM. The ESA review maintains the double voting system in the EBA Supervisory Board that was put in place after the creation of the SSM, but does not do anything more.

5) Changes to legislation should be the result of a dynamic process, whereby the Commission should have the legal obligation to demonstrate (through objective predefined criteria) that efficient supervision could still be based on cooperation between supervisors and mutual recognition, or it should be exercised directly by an ESA, more in particular ESMA. To give a clear example, if the market for a financial product exists only in a few countries and is very local, supervision should stay at the national level. But if the objectives of that piece of legislation relating to a product or a market are to encourage a more integrated market, or the risk has become more EU-wide, then the decision should be to empower ESMA. In other words, decisions to increase ESMA's powers should be taken in product- or market-specific legislation every time they are reviewed, not as part of the ESMA Regulation.

Following a long, regulatory post-crisis process aiming at restoring confidence and formulating a Single Rulebook, the Commission has, with the ESA review, triggered a process for further supervisory integration to ensure consistent implementation. This goes in the right direction, particularly in the context of forging a post-Brexit CMU. But **the proposal tries to kill too many birds with one stone.** The governance of the ESAs should be better aligned with the level of integration that will result from more EU-wide supervisory action. This can be achieved by giving a say to permanent executive members in the Board of Supervisors on supervisory issues

[2] Willem-Pieter de Groen and Klaudia Zielinska, "European Supervisory Authorities still playing second fiddle to national financial authorities", CEPS Commentary, CEPS, Brussels (2018, forthcoming).

and by setting an ambitious selection process for the chairperson and executive board members going beyond mere administrative grades and processes.

As regards the new areas of direct supervision given to ESMA, apart from the current obvious cases (benchmarks, CCPs, ELTIFs and data providers), transfers to the EU level should be the result of a dynamic process following an assessment of the degree of market integration based on objective key indicators (the cross-border nature of the business, number of market players, standardisation of products, contagion risk, etc.) when product- or market-specific legislation is periodically evaluated. Finally, the ESAs' relationships with third countries should be conceived as one of the components of a wide strategic thinking of what a post-Brexit CMU should be. So far, such vision is missing.